

Inclusive Framework BEPS Agreement

Update on Pillar 2 agreement – December 2021

Policy Perspectives update – Hong Kong SAR



Release of the GloBE model rules under Pillar 2 of BEPS 2.0

On 20 December 2021, the OECD/G20 Inclusive Framework (IF) on Base Erosion and Profit Shifting released the GloBE model rules together with a summary, a fact sheet and frequently asked questions. These documents can be accessed via this [link](#). For our brief update on the release of the GloBE model rules with a discussion of the Hong Kong specific tax policy considerations, please refer to this [link](#).

Summary of the new rules

For a summary of the GloBE model rules, the major differences between the model rules and the rules set out in the Pillar 2 blueprint issued in October 2020 and the coming implementation process and timeline announced by the OECD, please refer to our global BEPS publication in this [link](#).

Hong Kong business considerations

General issues

- **Domestic top-up tax** – Jurisdictions can introduce a domestic top-up tax regime that operates in a way consistent with the outcomes of the GloBE rules. Instead of being treated as a covered tax, the domestic top-up tax payable under such regime will be credited against the GloBE top-up tax to come up with the jurisdictional top-up tax amount. This means that even if an MNE group's jurisdictional effective tax rate (ETR) in Hong Kong reaches 15% due to any domestic tax regime (DMT) regime in Hong Kong, the group's compliance burden of computing the jurisdictional top-up tax amount is not relieved unless a safe harbor linked to the presence of such DMT regime will be introduced. The Hong Kong SAR Government has indicated it will look at measures to capture tax on activities in Hong Kong. How this tax would be treated for the GloBE rules purposes will need to be carefully considered.
- **The expanded scope of the UTPR** – The UTPR can now be applied to deny deduction (or make an equivalent adjustment in form of a deemed taxable income or an additional tax) of all tax-deductible payments (including payments made to unrelated third parties) instead of related-party payments only. In addition, the maximum amount of UTPR top-up tax allocated to a constituent entity (CE) will no longer be limited by the amount of related party payments made. This means MNE groups will have little room to mitigate the UTPR tax exposure by rearranging the flow of their intra-group payments. This also signifies a policy shift from using the UTPR to address the BEPS issue arising from intra-group payments (from high-taxed CE to low-taxed CE) to using the UTPR as a means to ensure the low-taxed income of a MNE group is subject to tax at the minimum rate of 15%.
- **Treatment of tax losses** – Tax losses carried forward are common in many groups operating in Hong Kong, especially because there is no group tax consolidation regime in Hong Kong. The GloBE rules

treat the deferred tax asset arising from prior year tax losses (recast at the lower of the 15% minimum rate and the domestic income tax rate in general) as a covered tax, excluding the impact of any valuation adjustment or accounting recognition adjustment. There is an option to use a GloBE Loss Election which provides an alternative deemed deferred tax asset. The potential benefit of making such election should be explored.

- **Significance of accounting policies and treatments** – The adjusted deferred tax accounting approach is now used to deal with accounting (book) to tax timing difference. In addition, the accounting treatments of certain items (e.g., whether to adopt the fair value accounting approach in respect of an asset or recognise an income in the profit and loss or other comprehensive income) may impact the computation of the jurisdiction ETR in a given year. As such, in-scope MNE groups should review the accounting policies and treatments currently adopted and consider whether any changes will be desirable.

Industry-specific issues

Financial services

- While investment funds and their special purposes vehicles (SPVs) are excluded from the scope of the GloBE rules, the exclusion only applies when the specified conditions are met (e.g., either the fund or its management has to be subject to a regulatory regime). There are also areas of uncertainty for the holding and operating structures used by funds as the SPVs can only hold assets, invest funds or carry out ancillary activities in order to qualify as an excluded entity.
- In Hong Kong, the distributions from regulatory capital securities (RCS) issued by banking groups are treated as deductible interest expenses for profits tax purposes but are commonly treated as dividends / distributions from equity for accounting purposes. The GloBE rules contain special provisions to deal with this mismatch between the accounting and tax treatments for distributions from Additional Tier One Capital so that such distributions will be treated as an expense in the computation of GloBE income or loss.

Real estate

- A five-year election is now available to exclude unrealised gain or loss from revaluation of all assets and liabilities (including immovable property) of a CE recognized in the financial accounts for the purposes of computing the GloBE income. It appears that the election can be rolled over indefinitely and until the disposal of the immovable property. However, this only deals with the timing difference arising from such revaluation gain or loss but not the permanent difference in the case where the realised gain or loss from disposal of the immovable property is capital in nature and not subject to Hong Kong profits tax. MNE groups with significant immovable property holding should assess the impact of Pillar 2 on them.
- Real estate investment trust (REIT) can now be treated as an excluded entity and not subject to the GloBE rules when certain conditions are met. REITs operating in multiple jurisdictions should assess whether the specified conditions can be met and if not, whether any changes to the REIT holding structure will be desirable.

Shipping

- International shipping income is excluded from the computation of GloBE income or loss for the purposes of computing the jurisdictional ETR and is not subject to GloBE top-up tax. The definition of “international shipping income”, which includes income from leasing a ship subject to fulfilment of certain conditions, should reduce the impact of Pillar 2 on the effectiveness of the ship leasing tax incentive in Hong Kong.
- In particular, the definition includes *income from leasing a ship on a bare boat charter basis, for the use of transportation of passengers or cargos in international traffic, to another CE*. This should address

shipping groups' concern that under their operational model, a ship is very often owned by a CE within the group which is a SPV and then leased to another CE in the group that operates the ship to derive ship transportation income.

- Hong Kong shipping groups that wish to apply this exclusion need to keep sufficient documentation to demonstrate that the strategic or commercial management of all ships concerned is effectively carried on within Hong Kong.

Concluding remarks

The release of the GloBE model rules brings the international community one step closer towards the implementation of an unprecedented global minimum tax under the BEPS 2.0 project. Subsequent to the release of the GloBE model rules, the European Commission published a proposed EU Directive on 22 December 2021 for incorporating the Pillar 2 rules into the EU law. The proposed rules in the Directive generally mirror the GloBE model rules but are with a broader scope (i.e., the rules are not limited to cross-border situations but also apply to domestic groups). This means the UPE jurisdiction that is an EU Member State will be required to apply the IIR not only in respect of low-taxed foreign subsidiaries, but also low-taxed CEs located in the UPE jurisdiction.

The GloBE model rules are complex and can have significant impact on in-scope MNE groups.

Tax leaders of MNE groups should perform or re-perform an impact assessment based on the GloBE model rules to understand the potential impact of the rules on the groups and come up with a plan of action to deal with issues such as accounting and financial system upgrade, collaboration between tax and accounting teams, increased compliance burden and potential restructuring of holding or operating structure.

Tax leaders should also keep in mind the impact of any potential changes to the Hong Kong tax system to be effective from 1 January 2023 as a response to the European Union's grey list for tax purposes as this could affect the calculated ETR of the operations in Hong Kong.

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